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IN THE

Supreme Court of the United States.

OCTOBER TERM, A. D. 1934.

IN THE MATTER

of

THE CHICAGO, ROCK ISLAND & PACIFIC RAILWAY COMPANY, Debtor.

Nos. 479 and 480

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO, Petitioner, *vs.* THE CHICAGO, ROCK ISLAND & PACIFIC RAILWAY COMPANY, *et al.*, Respondents.

Nos. 481 and 482

THE CHASE NATIONAL BANK OF THE CITY OF NEW YORK, Petitioner, *vs.* THE CHICAGO, ROCK ISLAND & PACIFIC RAILWAY COMPANY, *et al.*, Respondents.

Nos. 483 and 484

MISSISSIPPI VALLEY TRUST COMPANY, Petitioner, *vs.* THE CHICAGO, ROCK ISLAND & PACIFIC RAILWAY COMPANY, *et al.*, Respondents.

Nos. 485 and 486

HARRIS TRUST AND SAVINGS BANK, Petitioner, *vs.* THE CHICAGO, ROCK ISLAND & PACIFIC RAILWAY COMPANY, *et al.*, Respondents.

Nos. 487 and 488

THE NEW YORK TRUST COMPANY, Petitioner, *vs.* THE CHICAGO, ROCK ISLAND & PACIFIC RAILWAY COMPANY, *et al.*, Respondents.

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

REPLY BRIEF FOR PETITIONERS.

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REPLY BRIEF FOR PETITIONERS.

The difficulties in the way of sustaining the decision of the court below are forcibly illustrated by the contradictory theories advanced by the various respondents in an effort to support the decision.

Respondents have filed three briefs, one on behalf of several Protective Committees, headed by the Committee for the Debtor's First and Refunding Bonds (hereinafter referred to as the First and Refunding Group), one on behalf of the General Mortgage Committee and one on behalf of the Debtor's Trustees. In substance, the first

of these represents the view of the junior lien holders; the second, the view of the senior lien holders; and the third, the view of the stockholders. In each brief, Section 77 is interpreted according to the special interests of the particular group represented. Respondents are united in purpose only by a common desire that the rights of petitioners be curtailed for the benefit of other creditors and the Debtor itself.

The following comments apply generally to all briefs filed by respondents:

1. None of said briefs answers, or attempts to answer, a main contention of petitioners that (a) a bankruptcy court in an ordinary bankruptcy proceeding is without jurisdiction to enjoin the sale of validly pledged collateral because, for one reason, the jurisdiction of such court extends only to property which is actually or constructively in the possession of the bankrupt at the time of the filing of the petition (save in specified cases not here material), and (b) there is nothing in Section 77 which would, contrary to the general bankruptcy rule, give to a bankruptcy court in a proceeding under that Section jurisdiction over validly pledged property which was not in the possession of the debtor when it filed its petition under Section 77.

2. Although conceding in effect that the injunction could not have been issued in an ordinary bankruptcy proceeding (First and Refunding Br., pp. 32, 35), none of respondents *finds any provision in Section 77 which authorizes the issuance of the injunction in the instant cases.* The First and Refunding Group and the General Mortgage Committee predicate the court's authority to issue the injunction upon the alleged necessity (from a practical

viewpoint) of such action in order to permit the consummation of a plan of reorganization. In the Trustees' brief, the authority to issue the injunction is based upon the theory that the approval of a petition filed under Section 77 crystalizes the status of all creditors as of the time of the filing of the petition, so that thereafter no individual creditor is at liberty to enforce an independent remedy for the realization of its rights.

The arguments of all the respondents are based upon two premises:

1. That Section 77 *guarantees* the ultimate reorganization of the Debtor, and, therefore, that the District Court had authority to issue any order necessary to insure the carrying out of a plan; and

2. That the sale of the collateral would prevent a reorganization.

It may be plainly demonstrated, petitioners submit, that these premises are unfounded.

I.

Section 77 does not *guarantee* the ultimate reorganization of the Debtor and consequently the District Court does not possess authority to issue any order necessary to *insure* a plan of reorganization.

Section 77 does not *guarantee* a plan of reorganization for every debtor who files a petition under that section. All that that Section provides is an *opportunity* to propose a plan.

A reorganization may be effected only if a plan is proposed which will, among other things, be acceptable to and approved by two-thirds in interest of each class of credi-

tors or will provide adequate protection for the interests of dissenting classes. If such a plan cannot for any reason be put into effect, then the proceedings under Section 77 must be dismissed. (See Section 77 (c) (7), and Section 77 (k); Appendix to R. F. C. brief, pp. 95, 104-105). If, because of events occurring prior to filing its petition under Section 77, the debtor's position has become such that a plan acceptable to the requisite number of its creditors cannot be proposed, then the debtor is relegated to its *status quo ante* the petition. Section 77 makes no provision for coercing certain creditors to the end that, by virtue of the relinquishment by such creditors of rights legitimately acquired and unaffected by bankruptcy, the other creditors, the debtor and its stockholders may obtain, in whole or in part, the same advantages they would have had if the debtor had not, prior to bankruptcy, created such rights.

Section 2 (15) of the Bankruptcy Act permits orders which are "necessary for the enforcement of the provisions" of the Act, but respondents point to no *provision* of Section 77 which the injunction enforces. Before any question of "enforcement" of a "provision" for reorganization is involved, it must first be shown that Section 77 provides—that is to say *requires*—that a reorganization must be consummated. Unless the Act makes the approval of a plan—perhaps even of a particular plan—mandatory (and, of course, it does not), there is no provision for a plan of reorganization to be enforced.

Respondents invoke Section 2 (15) not to enforce any "provision" of Section 77, but to enforce the asserted "*general purposes*" of Section 77. Clearly, petitioners submit, authority to issue the injunction is not thus to be *implied* in the face of (1) specific provisions in the Bankruptcy Act, not repealed by Section 77, which have been uniformly

construed not to disturb the rights of a pledgee to close out his collateral; (2) lack of power in a bankruptcy court, not in any wise remedied by Section 77, to deal with property not in the actual or constructive possession of the bankrupt; (3) provisions in Section 77 which negative an intent to confer the asserted authority; and (4) grave doubts as to the constitutionality of the asserted authority.

II.

A sale of the pledged collateral would not prevent a reorganization.

All respondents contend that the injunction was necessary if a plan is to be consummated, but they differ sharply as to the reasons for the alleged necessity. These differences arise chiefly because of a sharp conflict of views as to the legal effect of a sale by petitioners of the collateral.

The First and Refunding Group and the Trustees assume that a purchaser of the pledged bonds from petitioners would become the holder thereof and possess the same rights with respect thereto against the Rock Island and the mortgaged property as one who had acquired similar bonds prior to the filing of the Debtor's petition under Section 77. Since the pledged bonds are of a face amount in excess of the indebtedness owing to petitioners by the Debtor, these respondents assert that a sale of the pledged bonds would increase the outstanding indebtedness of the Debtor. On this basis, they assert that an injunction is necessary because (1) an increase in the indebtedness of the Debtor might interfere with the acceptability of any plan by the various creditors and stockholders, and (2) if there were no injunction, there would be insuperable

mechanical difficulties in working out a plan of reorganization arising from the "continuing uncertainty" as to the amount and classes of creditors to be taken care of in any plan.

The General Mortgage Committee, on the other hand, argue that the effect of the filing of the Debtor's petition under Section 77 was instantly to extinguish any personal obligation of the Debtor upon the pledged bonds, with the result that such bonds became in effect mere evidences of a *pro tanto* interest in the mortgaged property underlying those bonds, and they argue that, if the collateral is sold, the purchasers will acquire no claim thereon against the Debtor but will acquire merely a right to share in the property mortgaged to secure such bonds.[1] On this theory, there would, of course, be no increase in the "indebtedness" of the Debtor upon a sale of the bonds. The General Mortgage Committee, however, argue that the injunction was necessary to avoid mechanical difficulties in working out a plan. They assert that a sale of the collateral would create a new class of creditors—a class holding bonds which are secured by a lien on the mortgaged property but which carry with them no personal obligation of the Debtor —and that if sales are made from time to time, a plan could not be worked out, since the proponents thereof would never know the amount of new securities required to be set apart for such class.

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[1] The General Mortgage Committee argue that the pledged bonds are not now outstanding obligations of the Debtor in the face of payments, made after filing of the Debtor's petition and even subsequent to the injunction, of interest on the General Mortgage Bonds pledged to secure the First and Refunding Bonds. Petitioners, as pledgees of First and Refunding Bonds, received a proper *pro rata* share of this payment. (See First and Refunding Br., p. 22; R. 342.)

The legal premises upon which the argument of the General Mortgage Committee is based raise questions of vast importance in view of the exceedingly large amount of collateral loans made by petitioners and banks generally which are secured by the mortgaged bonds of the borrowers themselves. If bankruptcy of a borrower *ipso facto* destroys said bonds as personal obligations of the borrower, it is obvious that after the bankruptcy of the borrower such bonds will be less valuable than like bonds carrying the borrower's personal obligation, and that, as a practical matter, the pledgee might, therefore, have difficulty in obtaining a purchaser therefor. Indeed, it is not going too far to state that a decision by this Court that purchasers of the Rock Island bonds, held by petitioners, would not acquire a personal claim on such bonds against the Rock Island would have a more far-reaching and harmful effect upon petitioners, and many other banks similarly situated, than a decision sustaining the injunction.

Petitioners deny the legal premise upon which the argument of the General Mortgage Committee is based, and assert that, notwithstanding the filing of the Debtor's petition under Section 77, petitioners are able (apart from the injunction) to transfer the Rock Island bonds held by them, so that the purchasers thereof would hold such bonds with precisely the same rights therein as one who had acquired like bonds prior to the filing of the Debtor's petition under Section 77. The argument upon which this view is based is set forth in the Appendix to this brief (pp. 23-50, *infra*).

Petitioners contend, however, that it is not necessary for this Court to determine the precise legal rights which purchasers of the pledged bonds would acquire. Petitioners contend that, whatever may be the legal incidents of

the pledged bonds held by them, they are entitled to sell them pursuant to the pledge agreements. Furthermore, petitioners contend that on either the theory of the First and Refunding Group and the Trustees as to the legal effect of a sale of the pledged bonds, or the theory of the General Mortgage Committee, there is no basis for respondents' contention that a sale of the collateral would prevent a reorganization.

The chief reasons advanced by the First and Refunding Group, and the sole reason advanced by the General Mortgage Committee, as to the necessity for the injunction, are purely mechanical ones—*i. e.*, they assert that an injunction is necessary in order to prevent *mechanical difficulties in working out a plan.* They argue as follows: In order to work out a plan, it is necessary to know the amount and classes of the outstanding indebtedness; if there were no injunction, the pledgees could at any time sell the pledged collateral; at each sale the class of creditors consisting of the holders of the bonds sold would be increased [the General Mortgage Committee contend that a sale of the pledged collateral would create a *new class* of creditors and that each subsequent sale would increase such class]; it would be impossible from a mechanical viewpoint to work out a plan if the amount and classes of outstanding creditors were subject to "unpredictable shifts" and if there were "continuing uncertainty" as to when the collateral would be sold.

With all deference to learned counsel, petitioners respectfully submit that these so-called mechanical difficulties are shadows without substance and afford no basis for saying that the injunction was necessary.

No plan was before the District Court when the injunction was sought, and none has since been formulated. If respondents had not secured the injunction, it is likely that petitioners would long since have sold all the collateral—an act which would have completely and finally eliminated any problem of "unpredictable shifts" or "continuing uncertainty" as to the size of classes.

A short answer to respondents' argument is that many railroads have in the past been reorganized in equity proceedings without resort to an injunction against the sale of pledged collateral. Although there may be some mechanical differences between a railroad reorganization under Section 77 and the familiar railroad reorganization in an equity proceeding, it is clear that at some stage in the latter proceeding, as well as in the former, the interested parties must know with exactness the precise amount of outstanding claims and classes of creditors. In view of the well established custom of railroads to secure funds by the pledge of their own secured obligations, it is only reasonable to assume that in some of these equity reorganizations there were outstanding collateral loans of the character involved in the instant cases; certainly, in most of such equity reorganizations, there were outstanding collateral trust indentures similar to those in the instant case. (See R. 66.)[2]

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[2] Petitioners have no basis for determining the accuracy of the statement made by the First and Refunding Group (Br., p. 16) that, according to a statistical survey made by them—not made available to petitioners—the ten major railroad systems which have been reorganized since 1910, had no substantial collateral loans outstanding. This statement is clearly inaccurate if it is intended to apply to collateral trust indentures. (See, for example, the facts with respect to the collateral involved in the St. Paul receivership, Moody's, Steam Railroads, 1926, p. 1108 (par. 5), and pp. 1109-1110 (pars. 10 and 11).)

Most of respondents' asserted mechanical difficulties arise from an unwillingness to recognize that the pledged bonds of the Rock Island held by petitioners are presently outstanding obligations of the Rock Island, subject only to the Debtor's right to redeem by paying the indebtedness (see pp. 25-47, *infra*). Being presently outstanding, there is no uncertainty as to the *total amount* of the now outstanding bonds, and, unless the Debtor pays the indebtedness owing to petitioners, the First and Refunding Bonds of the Debtor held by petitioners must be provided for in any plan of reorganization to precisely the same extent (certainly where, as here, the present market value of the pledged bonds is less than the amount of the indebtedness owing) as similar bonds held by the public generally. Accordingly, a sale of the First and Refunding Bonds held by the petitioners would not increase the amount of such bonds outstanding or the amount of such bonds to be taken care of by the issuance of new securities. The size of the *class* being presently fixed, a sale of the pledged bonds would not increase it, but would merely substitute one holder for another.

Moreover, there are no mechanical difficulties which necessitate this injunction, even if it be assumed that a sale of the pledged bonds would increase the class of creditors holding such bonds.

In an ordinary bankruptcy liquidation proceeding it is necessary *ultimately* to know the precise amount of outstanding claims of all classes. But this fact has never required an injunction against the sale of pledged bonds of the bankrupt. The claim of a pledgee holding pledged bonds of a bankrupt in an ordinary bankruptcy proceeding cannot be allowed until the value of his security has been determined. The pledgee may, if he chooses, deter-

mine this value by selling the collateral. But if he does not, the court may direct the determination of such value "by agreement, arbitration, compromise, or litigation" (Sec. 57 (h); U. S. C. A., Title 11, Sec. 93 (h)). The requisite certainty as to the total outstanding claims of all classes is insured by the fixing of a time within which all claims must be filed.

The situation would be no different in a proceeding under Section 77 even on the assumption, the most favorable to respondents, that the proof of secured claims in a proceeding under Section 77 should be governed by the bankruptcy rather than the equity rule.[3] Section 77 (c) (5) provides (Appendix to R. F. C. Br., p. 95) that the court shall—

> "* * * determine a reasonable time within which the claims and interests of creditors and stockholders may be filed or evidenced and after which no such claim or interest may participate in any plan except on order for cause shown."

In the instant cases, the District Court, on January 23, 1934, entered an order classifying creditors and stockholders, but expressly refrained from fixing a time for the filing of claims, except as to a few classes of claims not here material. (Appendix to R. F. C. Br., pp. 133, 140). Ultimately, at the proper time for formulating a plan, the District Court will fix a date prior to which these petitioners and all other claimants must file their claims, and the neces-

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[3] As is pointed out in the Appendix, *infra*, pp. 23-50, petitioners contend that inasmuch as Section 77 provides for the reorganization of the debtor rather than the liquidation of the debtor's estate, the equity rule is more properly applicable to a proceeding under that Section. If such equity rule does govern, the respondents are, *a fortiori*, in error, since the First and Refunding Bonds held by the petitioners are outstanding to the same extent as like bonds of the same issue.

sary effect of that action will be to force petitioners to determine the value of their collateral (which is necessary before petitioners can ascertain the amount of their *unsecured claims*) either by a sale thereof according to the pledge agreements, or in one of the other ways provided by Section 57 (h). But until that time arrives, there is no necessity (from the mechanical point of view of working out a plan of reorganization) for enjoining a sale.

If respondents want to know the precise amount of outstanding claims, they should ask the District Court to fix a period for the filing of claims. If and when that time arrives (which will not be until there is some necessity for knowing exactly the amounts and classes of claims), and the petitioners have not sold their collateral or the Debtor's Trustees have not redeemed it, there will be time enough to consider whether—in order to know the precise amount of the outstanding claims—the Court can require petitioners to determine the value of the collateral they hold by a sale thereof, or otherwise. Until a period has been fixed for the filing of claims no one interested in a plan is in a position to know, or demand to know, with precise certainty the amount and classes of outstanding claims.

In other words, the mechanical requirement of certainty as to the amount of claims can *never* justify a *restraint* upon the pledgees' right of sale, although, conceivably, the *forcing* of such a sale may be ultimately necessary in order *to fix the value of petitioners' unsecured claims.*

Moreover, the alleged mechanical difficulties conjured by respondents are all predicated upon the preparation and working out of a plan. When the Debtor's petition for an injunction was filed, no plan was in process of preparation. No plan is yet in preparation, and less than two months ago the Debtor's Trustees advised the Interstate Com-

merce Commission that there was no immediate likelihood of any plan being formulated. (Appendix to R. F. C. Br., pp. 167-173). Whatever effect, if any, a sale of the collateral might have upon the mechanics of working out a plan in process of preparation, such considerations *are wholly irrelevant when no plan is in process of formulation.*

The First and Refunding Group supplement their argument with respect to the alleged mechanical difficulties by asserting that if petitioners are permitted to sell the collateral the amount and character of new securities to be issued will be affected. They argue (First and Refunding Br., pp. 12-13):

> "* * * if the R. F. C. and the Banks retain their collateral, not more than $17,784,877 in securities need be provided * * * to retire these loans and take up the $54,711,465 of collateral. * * * But, if the R. F. C. and the Banks finally sell all their collateral, * * * $54,711,465 in lower grade securities must be provided in the plan of reorganization in place of $17,784,877 in cash or securities."

This argument assumes, without basis, that in any plan of reorganization the petitioners and the R. F. C. will receive only cash or new securities in an amount determined by the face amount of their claims ($17,784,877). This assumption is obviously not well founded where, as here, the value of the pledged bonds is less than the face amount of petitioners' claims. If the present value of the pledged collateral is less than the amount of petitioners' claims secured thereby, it is clear that petitioners must receive, for each pledged bond, the same amount of new securities as do any other holders of bonds of the same issue, and, *in addition,* must receive securities, or be otherwise compensated for, the value of their *unsecured claims.*

But, even if it be assumed that the amount and character of the new securities to be issued under any plan will be different if the pledged collateral is sold from what they will be if the pledged collateral is not sold, it does not follow that a sale of the collateral will prevent the working out of *a plan;* it means only that a sale of the collateral may require *a different sort of plan* than would be required if the collateral were not sold. But, as made clear in petitioners' main brief (pp. 58-60), Section 77 does not guarantee any plan, let alone any *particular kind of plan,* and does not provide for any plan which will require secured creditors to abandon their favored position for the benefit of unsecured creditors or the Debtor's stockholders.

In addition to the arguments above set forth, the First and Refunding Group contend that a sale of the pledged collateral would so magnify the capitalization of the Rock Island that it would "disastrously affect the acceptability to the creditors and the stockholders whose assent thereto is necessary." (First and Refunding Br., p. 11). This is a pure assertion, unsupported by any facts. It is predicated primarily on the assertion (First and Refunding Br., p. 7) that a decision that the petitioners could not be enjoined from selling the pledged collateral would also determine that the trustees of three bond issues of the Debtor would have the right to sell $145,749,050 face amount of bonds and stock of the Debtor's System pledged with such trustees. This latter assertion is likewise without foundation. It is based solely on the allegation in Mr. Beebe's affidavit (R. 66-67) that:

> "In certain events described in the Indenture under which the aforesaid Trustees are acting, such Trustees are given the right to sell such collateral."

What such "certain events" are does not appear. Whether a decision that the petitioners could sell their collateral would determine the right of the trustees under the Debtor's mortgages to sell the collateral pledged with them depends, of course, upon the terms and conditions of the trust indentures. *But the record does not disclose such provisions.* If the Court is to speculate as to what such provisions might be, petitioners point out that it is very unlikely that collateral pledged under a trust indenture to secure a bond issue running for eighteen years (see R. 65) would be held under terms ordinarily applicable to a pledge of collateral to secure a short term bank loan.

Finally, even assuming that the trustees under the Debtor's Mortgages can and will sell the collateral pledged with them if there is no injunction against petitioners, there is nothing before the Court which warrants the statement that a plan can be worked out if the Debtor's capitalization is $400,000,000 but cannot be worked out if such capitalization is increased by $50,000,000 or more.

Apart from the foregoing, it is apparent that a sale of the collateral has little bearing upon a reorganization.

A sale of the collateral would not dispose of or affect the railroad properties which secure the bonds of which the collateral consists. After such a sale, those properties would still belong to and be in the possession of the Debtor and/or its Trustees, and would be just as available for operation and inclusion in a plan of reorganization as before such a sale. If it be assumed that these properties would be subject to a greater amount of claims after such a sale, the only result would be to require the additional claims to be taken into account in the plan—the plan could still be consummated if approved. It might not be so favorable to

other creditors, or it might be a different plan from that which would have been put into effect if no sale had taken place, but a plan of reorganization would not be prevented by such sale. So long as the Debtor has assets, some kind of reorganization is presumably possible and practicable.

To argue that any particular act would make a reorganization *unacceptable* is to indulge in mere conjecture in the absence of a polling of creditors and stockholders, or at least some evidence of facts tending to show that a plan will be proposed and approved if such act is enjoined. But assuming that any plan which could be proposed after the sale would be unacceptable to the interested parties, Section 77 does not *insure* an acceptable—or any—plan, and the true cause of the unacceptability must be the financial condition generally of the Debtor. It seems as unfair to require petitioners to give up their right of sale as it would be to ask other creditors to relinquish a part of their claims, although this waiver of a part of other creditors' claims might tend to bring about the approval of an otherwise unacceptable plan.

Respondents concede that secured creditors cannot be restrained from selling third party (as distinguished from the Debtor's own) obligations. Assume that the collateral consisted of valuable bonds or stocks of a railroad, or any other corporation, having no connection with the Debtor—securities having no readily realizable market value but great potential and intrinsic value. These securities, respondents argue, could be sold and yet their value, in proportion to remaining assets of the Debtor and its capitalization and indebtedness, might be so great as to make any plan of reorganization impracticable after the sale. Such a sale would actually take assets out of the estate; a sale of the Debtor's own obligations would have no effect upon

the assets of the estate. Yet respondents say the first sale should not be restrained and the latter should be. Surely their argument cannot be based on the premise that the first sale (taking assets out of the estate) would not prevent a reorganization while the latter sale (leaving assets unaffected) would prevent a reorganization. In fact, the argument is and must be that a sale of the Debtor's own mortgage obligations would require the proposal of a plan, which other creditors would find more unfavorable to them than the plan which might have been presented if the sale had not taken place. Therefore, the sale must be enjoined, not because it would prevent a plan, but in order to obtain the approval of a plan by other creditors.

III.

The contention of the Debtor's Trustees as to the construction of Section 77.

Of the various theories advanced by the respondents, the only one which attempts logically to justify the injunction on the basis of interpretation of Section 77, is that advanced by the Debtor's Trustees. The difficulty with the Trustees' theory, however, is that it is founded on what the stockholders of a financially embarrassed railroad wish Section 77 provided rather than on what that Section actually does provide.

The Trustees contend that the effect of the approval of a petition filed under Section 77 is instantly to freeze into immobility all the claims, secured and unsecured, against the Debtor—an immobility which can only be altered or relieved pursuant to a plan of reorganization worked out

under the supervision of the Interstate Commerce Commission. They assert (Trustees' Br., p. 7):

> "* * * From the moment the petition is approved * * *, the Act impounds the rights of all, so to speak, until the reorganization plan is consummated, to the end that through a readjustment, modification, or alteration of the rights of the creditors, secured or unsecured, and of the stockholders, the capital structure and the physical properties of a financially embarrassed railway company may be so reorganized, under the supervision of the Interstate Commerce Commission, as to enable the corporation to continue to function and adequately to serve the public."

That the Trustees' construction of Section 77 should be one wholly at variance with anything suggested by the respondent Committees or by the court below and, indeed, at variance with the provisions of Section 77 itself, is not surprising in view of the fact that such construction is squarely predicted upon the assumptions (1) that Section 77 "is not essentially a bankruptcy act" (Trustees' Br., p. 1), and (2) that "the interpretation of Section 77 cannot be predicated upon cognate provisions of the Bankruptcy Act; for the purposes of the Acts are diametrically opposed to each other." (Trustees' Br., p. 9).

The error of this premise, apart from the fact that it would destroy the constitutional foundation of Section 77, is apparent when it is considered that—

> 1. Section 77 was enacted as an integral part of the Bankruptcy Act (Section 73; U. S. C. A., Title 11, Sec. 201).
>
> 2. The purpose of Section 77 was to bring railroads "under the bankruptcy jurisdiction of the

Federal court" (H. Rept. No. 1897, 72d Cong., 2d Sess., p. 16).

3. Section 77 (n) provides that in a proceeding under Section 77, and consistent with the provisions thereof, "the jurisdiction and powers of the court • • • shall be the same" as in an ordinary voluntary bankruptcy proceeding.

The Trustees' Brief is so replete with statements not warranted, either expressly or by implication, by anything in Section 77, or otherwise, that it would be impracticable to reply to all of them. To illustrate, the Trustees assert (Br., p. 11) that all creditors, including holders of securities, must "defer individual action for the realization of their rights, and await the formulation of a plan." If this were not so, the Trustees assert, the creditors "by their own act, could eliminate themselves from the reorganization plan, and thus defeat the very purpose of the amendment." But plainly, the elimination of any creditors, by wholly extra-legal action in accord with a conceded contract right, would tend not to prevent but, rather, to facilitate a reorganization.

Similarly, the Trustees assert (Br., p. 12) that the equity of the Debtor in the pledged securities "is property of the debtor", and as such property *must* be provided for in a plan of reorganization. Petitioners have no objection to the reorganization of the Debtor's "equity", if any, in the pledged collateral; they object to an attempt to reorganize the pledged collateral itself—*i. e.*, property not in the possession of the court and not part of the Debtor's estate.

The Trustees' theory of construction is predicated chiefly upon one of the definitive provisions of the statute—

subdivision (b) (1)—which provides (Appendix to R. F. C. Br., p. 93) that—

> "A plan of reorganization within the meaning of this section (1) shall include a proposal to modify or alter the rights of creditors generally, or of any class of them, secured or unsecured * * *."

The Trustees interpret this provision to mean that every plan of reorganization under Section 77 *must* modify or alter the rights of all secured creditors. Plainly, this construction is unwarranted, since otherwise it would be impossible to work out any plan of reorganization without modifying the rights of *all* secured creditors, including those holding underlying securities so well secured that equity would require that such securities be left undisturbed. Furthermore, this very subdivision contemplates by its express terms that the rights of "any class"—not every class—of secured creditors may be modified or altered. Even if we should give to the word "shall" the distorted emphasis ascribed to it by the Trustees, still all that the statute would provide is that a plan shall include a *proposal* to modify, etc. Clearly, the question whether the *proposal* should be made a *provision* of the plan is one left to the determination of the Interstate Commerce Commission and the courts.

A short and sufficient answer to the Trustees' theory of construction is that the words "secured creditors", as used in various places in Section 77, must, in so far as is consistent with the provisions of Section 77, be construed with respect to the rights of such creditors, and the jurisdiction and powers of a bankruptcy court with respect to such creditors, as such jurisdiction and powers have been determined by the courts in ordinary bankruptcy proceed-

ings, unless some provision in Section 77 can be pointed to which *requires* a different result. No such provision is referred to in the Trustees' brief.

Respectfully submitted,

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APPENDIX.

SUPPLEMENTAL MEMORANDUM IN SUPPORT OF PETITIONERS' CONTENTION THAT A PURCHASER OF THE DEBTOR'S FIRST AND REFUNDING BONDS HELD BY PETITIONERS WOULD HAVE THE SAME RIGHTS WITH RESPECT THERETO AGAINST THE DEBTOR AS ONE WHO ACQUIRED LIKE BONDS PRIOR TO THE FILING OF THE DEBTOR'S PETITION UNDER SECTION 77.

The injunction against the sale by petitioners of their collateral was sought and obtained in the District Court on the theory that a sale of such collateral (consisting of secured obligations of the Debtor in a face amount substantially in excess of the Debtor's notes held by petitioners) would increase the outstanding indebtedness of the Debtor and thus dilute the interests of other bondholders and creditors. (See R. 40.) This theory was based on the assumption that a purchaser of the pledged bonds held by petitioners would have the same rights with respect to such bonds against the Debtor and its property as any holder of like bonds which were acquired prior to the filing of the Debtor's petition under Section 77.

In the Circuit Court of Appeals one of the respondent Committees, the Protective Committee for the Debtor's General Mortgage Bonds, made the contention that the effect of the filing of the Debtor's petition under Section 77 was instantly to extinguish any personal obligation of the Debtor upon the pledged bonds, with the result that such bonds became in effect mere evidences of a *pro tanto* interest in the mortgaged property underlying those bonds; and they contended further that if the pledged bonds were

thereafter sold, the purchasers would acquire no claim against the Debtor upon the pledged bonds, but would acquire merely a right to share in the mortgaged property securing such bonds. That Committee makes the same contention in this Court.

If that contention were sound, it would mean that by the mere act of the Debtor in filing its petition under Section 77 the value of the pledged bonds would be greatly reduced, since, obviously, the sale price of "bonds" carrying no personal obligation of the Debtor would be substantially smaller than that of bonds carrying the personal obligation of the Debtor.

The General Mortgage Committee concedes (General Mortgage Br., p. 34) that if the pledged bonds were sold *prior to the institution of proceedings under Section 77,* the purchasers thereof would acquire a valid title thereto and rights therein against the Debtor and its property precisely the same as those of any other holder of bonds of the same issue. And it is clear that it was the intention of the parties that petitioners should, upon default of the Debtor, have the right to sell the pledged bonds—*i. e.,* the right to convey an absolute title thereto, including a claim against the Debtor for the face amount of the bonds.

The pledge by a corporation of its own bonds is an established method of corporate financing, and the courts have uniformly held that neither insolvency nor bankruptcy interferes with the right of a pledgee to sell such pledged bonds upon a default by the pledgor. Since the decision of this Court in *Jerome* v. *McCarter,* 94 U. S. 734 (1876), and the decision in *In re Ironclad Mfg. Co.,* 192 Fed. 318 (C. C. A. 2d, 1912), the business world generally has

assumed as a matter of course that the right to sell such pledged bonds after bankruptcy of the pledgor connoted the power to vest in the purchaser thereof the same rights with respect to such bonds as are possessed by one who acquired such bonds prior to such bankruptcy.

The General Mortgage Committee have, however, submitted an exhaustive brief in which they attempt to establish a contrary conclusion. Although petitioners believe that the question of what rights would vest in a purchaser of the pledged bonds from petitioners at a sale subsequent to the filing of the Debtor's petition under Section 77 is not involved in the instant cases, for reasons set forth in their main brief, and in their reply brief, petitioners have deemed it advisable to prepare this supplemental memorandum in answer to the contention of the General Mortgage Committee that petitioners cannot now sell the pledged bonds so as to convey an absolute title thereto.

For the purpose of this memorandum petitioners shall assume that *all* the pledged bonds held by them are First and Refunding Bonds of the Debtor.

I.

The First and Refunding Bonds pledged by the Debtor to Petitioners were upon the pledge thereof and are now valid and subsisting obligations of the Debtor.

In contending that if a pledgee of mortgage bonds of a corporate pledgor, after the institution of bankruptcy proceedings with respect to such pledgor, sells those bonds in accordance with the terms of the pledge agreement, the purchaser is not entitled to prove upon such bonds for their face amount, the General Mortgage Committee have,

it is submitted, confused the law of corporations and the law of pledge. Relying on the admitted fact that the rights of a pledgee are of a qualified character, the General Mortgage Committee contend that the bond, so long as it is in the hands of the pledgee, must necessarily be an imperfect obligation, and that since, under Section 63 (a) of the Bankruptcy Act, claims, to be provable, must be fixed and absolutely owing at the time of the filing of the petition, a sale subsequent to such time could not perfect the obligation and make it provable.

In so arguing, the General Mortgage Committee have overlooked the fact that in such a situation there are two obligations which must be treated separately—the obligation of the corporation as maker of the note incidental to which the pledge agreement was executed, and the obligation of the corporation as obligor on the mortgage bond. Respondents apparently assume that any claim asserted against the corporation on the mortgage bond is a claim asserted by the pledgee *as pledgee thereof.* This, petitioners will show herein, is an erroneous assumption. When the pledgee of that bond asserts any right against the corporate obligor on the bond, he does so *as the absolute obligee on that bond* without regard to the fact that the corporation is also obligated to him on a note, and that the bond is pledged as security for the indebtedness represented by such note. When, on the other hand, that pledgee asserts against the corporation any right on the note, he does so wholly apart and distinct from any right which he may have against the same corporation on the bond.

In so far as the rights of the obligee (the pledgee) on the corporation's mortgage bond are concerned, those rights are absolute and are not qualified by the fact that

he holds the bond as collateral securing that same corporation's note. True, the obligee's right to the *proceeds* derived from the enforcement of the obligation represented by the bond are necessarily qualified by the law of pledge, and if the proceeds derived from the enforcement of the bond are in excess of the amount of the corporation's obligation represented by the note, the obligee will be entitled to such *proceeds* only up to the face amount of the note. Similarly, the right of the payee of the note to enforce that note against the debtor is likewise unqualified.

True, the law of pledge controls the amount which the payee of the note will ultimately be entitled to retain from the proceeds derived from enforcing both the obligation represented by the note and the obligation represented by the bond securing such note. The operation of that law, however, affects only the ultimate distribution of the *proceeds,* and in no way affects the existence of valid separate and unqualified corporate obligations on both the note and the bond. In so far as the payee of the note, *as such payee,* asserts any right against the corporation, he asserts it only with respect to the indebtedness represented by that note; in so far as that same individual asserts any right against the corporation on the latter's mortgage bond, he asserts it solely as obligee on that bond without reference to the fact that at the same time he holds that bond as collateral securing another obligation of the same corporation.

The intervention of bankruptcy does not affect these two distinct obligations, and hence proof on the bonds should be permitted. True, so long as both the note and the bonds are in the hands of the pledgee, any amount received as dividends in excess of the face amount of the

note is held for the bankrupt pledgor's estate. The law of pledge imposes this limitation; it requires no greater. To bar proof on the bonds altogether is unwarranted by any provision of the Bankruptcy Act, or by any rule of corporate or pledge law.[4]

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[4] In an ordinary bankruptcy proceeding the creditor of the bankrupt before proving a secured claim is required, unless he surrenders the security, to realize on the security or have it appraised, and to deduct the sale price or the appraised value from the face amount of the secured indebtedness.

In an equity proceeding, on the other hand, a creditor of the insolvent need not account for the collateral securing the insolvent's obligation to him, the only limitation on his right being that the amount ultimately retained by him from the proceeds derived both from the collateral and proof of the secured obligation may not exceed the face amount of the obligation secured.

Although Section 77 was grafted upon the Bankruptcy Act, it provides for a procedure which in general is far more analogous to the equity proceeding than it is to the ordinary bankruptcy proceeding. Section 77 contemplates a reorganization of the debtor, not a liquidation of the debtor's estate. Heretofore, railroad reorganizations could be effected only through the medium of equity receivership proceedings. Petitioners submit that the rule followed in those proceedings should, therefore, be followed in proceedings under Section 77, and that such rule should not be abandoned in favor of the rule prevailing in *ordinary* bankruptcy proceedings which are fundamentally opposed both in purpose and procedure to a reorganization proceeding.

Furthermore, it is significant that petitioners made their loans to the Debtor herein at a time when there was no possibility of that Debtor's being reorganized under the Bankruptcy Act, and clearly at a time when they were entitled to believe that they were amply secured in that they could in any reorganization proceeding affecting the Debtor prove upon the claims represented by the Debtor's notes without regard to the collateral securing such notes.

Petitioners submit, therefore, that any attempt to apply the rule prevailing in ordinary bankruptcy proceedings to the instant situation would be unwarranted. Even if, however, the rules prevailing in ordinary bankruptcy proceedings were applicable to a proceeding under Section 77, it would follow only that in proving upon the notes, petitioners would be required to deduct the proceeds received as dividends through proof on the bonds; it would not follow at all that proof could not be had upon the independent obligations represented by the bonds.

Sale of the bonds, either before or after bankruptcy, in no way affects their provable character. Upon a sale of the pledged bonds, the limitation that dividends received through proof on the bonds in excess of the amount of the note are held for the bankrupt pledgor's estate is removed. This necessarily follows, since that limitation was imposed not by any rule of bankruptcy but by the law of pledge. The sale under the terms of the pledge agreement removes the pledged character of the bonds, and the limitations imposed by pledge law are consequently removed.

If it be contended that the recognition of such rights in the purchaser makes possible a variation in the total claims which may be filed against the debtor's estate and the dividends which may be payable on account of the bonds and the notes, the answer is that even in an ordinary bankruptcy proceeding the Bankruptcy Act does not prohibit that result. In every situation in which a creditor of a bankrupt holds security that result obtains. A secured creditor can never in an ordinary bankruptcy proceeding prove upon the full claim secured without reference to his security. He must, before proving, either sell his collateral or have it appraised, and deduct the sale price or the appraised value from his claim, or surrender the collateral. The claim filed and the total dividends payable, will necessarily vary according to which of these alternatives the secured creditor elects. Any such election must of necessity occur after the filing of the petition. Yet it has never been suggested that the fact of that variation makes claims unprovable. The claim presented is on a "fixed obligation * * * absolutely owing" at the time the petition was filed.

Admittedly, the above analysis is correct only if the bonds held by petitioners are valid and subsisting obligations of the Debtor. An examination of cases dealing with the pledge of a corporation's own mortgage bonds leaves no doubt that such is the case. A transaction in which a corporation pledges its own mortgage bonds as security for a present loan is recognized as a legitimate form of corporate finance. See Hatch, "*A Form of Depression Finance—Corporations Pledging Their Own Bonds*", 47 H. L. Rev. 1093.

Whether such procedure results in an "issue" of those bonds is, of course, a question of corporate law and is, therefore, governed by the law of the domicile of the pledgor corporation. The Debtor being an Illinois corporation, the answer to that question in the instant cases depends upon Illinois law.

In *Peacock* v. *Phillips*, 93 N. E. 415 (Ill., 1910), the court indicated that corporate bonds which

> "* * * are issued for the purpose of raising funds for the corporation and are intended to be thrown upon the market and to pass from hand to hand."

are validly issued obligations of the pledgor corporation. The court said (p. 417):

> " * * * The mortgage or trust deed secures the holders of the bonds, and they can be enforced by such holders for the full face value, regardless of equities. To permit equitable defenses to be interposed would practically destroy such methods of raising money, and the corporation is properly estopped to deny its liability."

Subsequent to the decision of the *Peacock* case, the Supreme Court of Minnesota in *Gilbert* v. *Fosston Mfg. Co.*, 218 N. W. 451 (Minn., 1928) had occasion to decide this question with respect to a situation governed by the law of Illinois. Relying upon the *Peacock* case, the Minnesota court said (p. 452):

> "That [the decision in the *Peacock* case] is controlling and disposes of this case. It makes no difference that the bonds were not negotiable. They were corporate obligations of the kind referred to in Peacock *v.* Phillips, and that is enough. That case follows the rule of the federal courts."

Although there seem to be no other Illinois cases on this point, it should be noted that in so far as provisions of the Illinois Constitution or Corporation Law are concerned, the situation is fully as favorable as in the other states in which it has been held that a pledge of such bonds by a corporate debtor constitutes an issue thereof. The doctrine appears to be accepted generally, except in Missouri. In some states there is no constitutional or statutory provision relating to the right of a corporation of that state to issue bonds. In other states there is a provision, either constitutional or statutory, prohibiting the issuing of stock or bonds except for money or property actually received, or labor done. Illinois falls in the latter group, Article XI, Section 13, of the Illinois Constitution providing, in part, that:

> "No railroad corporation shall issue any stock or bonds, except for money, labor or property actually received, and applied to the purposes for which such corporation was created;"

Although this provision of the Illinois Constitution seems never to have been construed with reference to this question by Illinois courts, it was construed by the Supreme Court of California deciding a case governed by Illinois law. In *Illinois Trust & Savings Bank* v. *Pacific Ry. Co.*, 49 Pac. 197 (Cal., 1897), the court held that a pledge by an Illinois corporation of its authorized but previously unissued mortgage bonds constituted a valid issue of those bonds. The court said on this point (p. 201):

> "By the constitution of Illinois it is provided that no railroad corporation shall issue stock or bonds except for money, labor, or property actually received and applied to the purposes for which such corporation was created. The constitution of this state (article 12, §11) contains a similar provision, omitting the clause as to application of the money, labor, or property. Upon these provisions appellant contends that it had no power to pledge its own bonds as collateral security. When the bonds were so pledged, and money or other property was actually received in consequence of such use of them, it seems to us that in a just and natural sense the bonds were issued 'for' such money or property. They served the purpose designed by the company,—procured value for it."

Identical rulings have been made in various other states in whose constitutions or statutes there appears a provision substantially identical with that in Section 13 of the Illinois Constitution. Thus in *In re Waterloo Organ Co.*, 134 Fed. 345 (C. C. A. 2d, 1904), which involved such a provision in the Laws of New York, the court said (p. 346):

"Counsel for the trustee objected on the ground that there was no valid consideration for the issue of the bonds, and that, as they were issued as collateral security without a present consideration, they were not issued for their fair market value, and therefore the issue was *ultra vires* and void.

"The referee has discussed the questions raised herein, and the authorities bearing thereon, and held 'that it was in the power of the corporation to pledge these bonds to the bank; that the bank is a lawful holder thereof, and, having proved them, they should be allowed in this proceeding'; and the court below has affirmed the order of the referee allowing the claim on said bonds. We concur in said decision."

Similarly, in *In re Goldville Mfg. Co.*, 118 Fed. 892 (D. S. C., 1902), aff. sub. nom. *William Firth Co.* v. *South Carolina Loan & Trust Co.*, 122 Fed. 569 (C. C. A. 4th, 1903), which involved such a provision in the South Carolina Constitution, the court said (p. 896):

"The fifth objection is that these bonds are invalid under section 10, art. 9, of the constitution of South Carolina, which provides that 'stock or bonds shall not be issued by any corporation save for labor done, or money or property actually received or subscribed; and all fictitious increase of stock and indebtedness shall be void.' This constitutional prohibition was evidently intended to provide against any issue of stock or bonds without consideration, * * * and can have no application here, where the bonds were issued for the purpose of paying for machinery already contracted for, and which actually went into the building. * * * It was a present consideration, and the company would not have secured the machinery except upon the assumption of the obligation to pay for the same."

In *Western Supply & Mfg. Co.* v. *United States & Mexican Trust Co.*, 92 S. W. 986 (Tex. Civ. App., 1906), with respect to such a provision appearing in the Texas Constitution, the court said (p. 987):

> "The Constitution provides that 'no corporation shall issue stock or bonds, except for money paid, labor done, or property actually received and all fictitious increase of stock or indebtedness shall be void.'
>
> "* * * The railway company had power under the Constitution to issue its bonds, and we think the authority is broad enough to embrace a pledge, as well as a sale of its bonds. When the bonds were pledged and money or property actually received as a result of such pledge, the bonds were in effect 'issued for' such money, and property."

And in *Atlantic Trust Co.* v. *Woodbridge Canal & Irrigation Co.*, 79 Fed. 842 (C. C., N. D. Cal., 1897), speaking with reference to like provisions appearing in the California Constitution and Code, the court said (p. 847):

> "The expression 'issue', in the constitution and Code, is certainly broad enough to cover a pledge as well as a sale of bonds. In the contemplation of law, bonds pledged by a corporation are just as much issued as when they are sold."

As to the general right of a corporation to effect a valid issue of its mortgage bonds through a pledge thereof, see, in addition to the foregoing cases: *Westinghouse Electric & Mfg. Co.* v. *Brooklyn R. T. Co.*, 288 Fed. 221 (S. D. N. Y., 1923); *Gilchrist Transp. Co.* v. *Phenix Ins. Co.*, 170 Fed. 279 (C. C. A. 6th, 1909); *Turner* v. *Metropolitan Trust Co.*, 207 Fed. 495 (C. C. A. 9th, 1913); *Equitable Trust Co.* v.

Great Shoshone & T. F. W. P. Co., 228 Fed. 516 (S. D. Idaho, 1915); *Worth* v. *Marshall Field & Co.*, 240 Fed. 395 (C. C. A. 4th, 1917).

Missouri appears to be alone (see Hatch, *ibid*, 47 Harv. L. R. 1093, 1117) in the view stated in *Dibert* v. *D'Arcy*, 154 S. W. 1116 (Mo., 1913), in which it was held that bonds so pledged were not "issued" and that

> "* * * in so far as these bonds constitute a personal liability of the Hardwood Export Company, they have no force whatever otherwise than as an evidence of the pledge of an interest in the lands mortgaged to secure them" (p. 1127).

The Missouri rule was the basis of the decision in *Mississippi Valley Trust Co.* v. *Railway Steel Spring Co.*, 258 Fed. 346 (C. C. A. 8th, 1919), which case has been extensively relied upon by the General Mortgage Committee. The rule of the *Mississippi Valley* case has no application in jurisdictions other than Missouri.

Questions as to the *effect* of the issue of a corporate bond by a pledge thereof may be raised in the following situations:

> 1. Where the pledgee of the bond seeks to enforce it against the corporate obligor while that corporation remains solvent;
>
> 2. Where a purchaser of the bond from the pledgee seeks to enforce it against the corporate obligor while that corporation remains solvent;
>
> 3. Where the pledgee of the bond seeks to prove a claim upon the bond against the estate of the insolvent obligor;
>
> 4. Where a purchaser of the bond from the pledgee, who purchased it before the insolvency of

the corporate obligor, seeks to prove a claim upon it against the estate of the insolvent obligor; and

5. Where a purchaser of a bond from the pledgee, who purchased it after the insolvency of the corporate obligor, seeks to prove a claim upon it against the estate of the insolvent obligor.

1. In the first of these situations, it is clear that the right of the pledgee to enforce a pledged bond is the same as that of any other holder of the corporation's bonds. "There is no reason why there should not be accorded to the holder of a corporate bond, who holds such bond 'by way of pledge from the issuing corporation for the corporation's own debt,' every right of a bondholder consistent with the right of the corporation to redeem." VI Fletcher, Cyc. Corp. (Per. ed., 1931), §2725. Thus, if interest payments upon the bonds become due while they are held in pledge, the pledgee-obligee is entitled to receive the interest; if the bonds mature during the life of the pledge, he is entitled to receive payment of the principal. *Smith* v. *Pillsbury,* 178 Pac. 719 (Cal. App., 1918). Likewise, if an action is brought to foreclose the mortgage securing the bonds while they are held in pledge, the pledgee-obligee is entitled to participate in full with the holders of other bonds in the proceeds available for distribution. *Duncomb* v. *N. Y., H. & N. R. R. Co.,* 84 N. Y. 190 (1881); *Peck* v. *N. Y. & N. J. Ry. Co,* 85 N. Y. 246 (1881).

True, in each of these situations the pledgee-obligee would be required to deal with such payments in accordance with the terms of the pledge agreement, and would be required to return to the pledgor any of such proceeds in excess of the amount of the principal indebtedness. *He does, however, have the right to enforce the obligation,*

clearly indicating that the pledged bond is a valid and enforceable obligation of the corporate obligor, *even in the hands of the pledgee.* The fact that the proceeds received from such enforcement must be held subject to the terms of the pledge arises entirely through the operation of the law of pledge. It in no way indicates that the right of the pledgee-obligee of bonds is in any way qualified as a matter of corporate law.

2. With respect to the second situation, it is equally clear that a purchaser of such bonds may enforce those bonds in their full amount. That right was upheld in *Gilbert* v. *Fosston Mfg. Co.*, 218 N. W. 451 (Minn., 1928), *supra*, where the court said (p. 452):

> "The doctrine of Dibert *v.* D'Arcy, in practical result, *disables a pledgee from selling the bonds of his debtor which have been pledged with him, although he has been given that right by a contract legally unobjectionable.* That power, absolute and unconditioned as it is ordinarily, *contemplates a sale and nothing less, and that good title shall be vested in the purchaser.* But under the rule of Dibert *v.* D'Arcy, there can be no power of sale in the real sense, but only the power, although the form of a sale be resorted to, of a bare assignment by the creditor of his right to use the collateral for the purpose of collecting his debt. Therefore, while that rule may achieve equity and avoid harsh results in given cases, it does seem to thwart the plain purpose of a lawful contract and to be in opposition to current lawful practices and purposes of business. Be that as it may, here it is the Illinois rule of Peacock *v.* Phillips that must control. *It follows that, by their sale as a pledge, appellant Baker got an unimpeach-*

> *able title to the bonds and may enforce them accordingly.''* (Italics ours.[5])

In *Farmers' Loan & Trust Co.* v. *Toledo & S. H. R. Co.*, 54 Fed. 759 (C. C. A. 6th, 1893), the court reached the same conclusion, and in *Gilchrist Transp. Co.* v. *Phenix Ins. Co.*, 170 Fed. 279 (C. C. A. 6th, 1909) the same court phrased the rule as follows:

> "If the debt be not paid, the pledgee may sell the bonds on giving notice to the pledgor, and the purchaser will take the mortgage as well as the bonds, and *may proceed to enforce the one by foreclosure and the other by an action at law, or he may do both.''*

See also *The Morris Canal and Banking Company* v. *Fisher*, 9 N. J. Eq. (1 Stockton) 667 (1855); *The Morris Canal and Banking Company* v. *Lewis*, 12 N. J. Eq. 323 (1858); *Hunt* v. *Memphis Gaslight Co.*, 31 S. W. 1006 (Tenn., 1895); *Rawlings* v. *New Memphis Gaslight Co.*, 60 S. W. 206 (Tenn., 1900); and *Medford* v. *Myrick*, 147 S. W. 876 (Tex. Civ. App., 1912), writ of error denied 150 S. W. xix.

These cases necessarily involve a holding that the bonds, when in the hands of the pledgee before sale to the purchaser, were valid and enforceable obligations of the pledgor-obligor. To assert that they indicate that such bonds are enforceable only in the hands of the purchaser would involve the proposition that by a mere sale the pledgee could make that an obligation of the pledgor which had not previously been such, whereas it is obvious that no one but the issuing corporation itself could create a valid obligation of that corporation. It is true

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[5] All italics used in quotations herein are supplied unless otherwise indicated.

that in the hands of a purchaser the bonds are free of that equity—the right to redeem—which adhered to them in the hands of the pledgee, but this is not to say that the character of the obligation represented by the bonds is in any way changed. It means rather that that equity in favor of the pledgor which previously attached to the bonds themselves has been transferred to the amount received upon their sale and hence the bonds themselves are thereafter free from that equity imposed, not by the law of corporations, but by the law of pledge.

3. In the third situation, in which the pledgee-obligee seeks to prove upon the bonds against the estate of the insolvent pledgor-obligor corporation, the right to prove is sustained by *Jerome* v. *McCarter,* 94 U. S. 734 (1876), when the Court said (p. 739):

> "There are some [bonds], it is true, that are still held in pledge; but the pledgees have a clear right to use them, *either by sale or by collection, until the full amount of the debts due from the mortgagors is satisfied.* • • • If, therefore, the holders of the the McCarter bonds, who hold them as collaterals, are allowed to hold them only for the sums for which they have been pledged, the bonds may, and probably will, prove an insufficient security for the debts actually due from the obligors to the holders. • • • If, at the sale, the mortgaged property shall bring more than sufficient to pay the debts for which the bonds are held in hypothecation, the proceeds of the sale will be under the control of the Circuit Court, and it will take care that a proper distribution is made. And if this were not so, the pledgees would hold any excess they might receive in trust for other incumbrancers, or for the appellants • • •."

In *Butterfield* v. *Woodman*, 223 Fed. 956 (C. C. A. 1st, 1915) it was stated that the assignee of the notes and the pledged bonds of the insolvent corporation was entitled to prove on both the notes and the bonds.

On the basis of the previous analysis herein made, these findings are clearly correct. The notes and the bonds are each independently valid obligations of the insolvent corporation and proof on both of them should be permitted. True, the right of the pledgee, as the holder of both the note and the bond, to participate in the dividends resulting from the proof of both obligations should be limited to such amount as will make him whole. But this is a limitation arising from the law of pledge and that limitation requires not that proof on one or the other of the obligations should be denied but only that the amount ultimately retained from the proceeds received from proving on both the obligations should not exceed the amount of the original indebtedness.

An opposite conclusion was reached in *Hitner* v. *Diamond State Steel Co.*, 176 Fed. 384 (C. C. Del., 1910), in which it was held that the pledgee could not prove in the receivership of the insolvent pledgor upon the pledged bonds held by it. The approach of the court, which led it into error, was that of splitting the bond into its promissory and security aspects, and then analogizing it in so far as its promissory aspect was concerned with an unsecured note pledged to secure a note.

It is true that it has frequently been held that the holder of an unsecured note pledged to secure another note of the maker cannot prove upon the pledged note against the insolvent estate of the pledgor. Assuming, for the sake of argument only, the correctness of such decisions,

it is improper to analogize that situation with one in which the pledgee holds secured bonds of the debtor in pledge. The courts in holding such pledged notes unprovable have based their decisions on the ground that a transaction involving the pledge of another note of the maker *is not a legitimate security arrangement*—that the giving of the second note is a vain thing—that it is a mere multiplication of the evidences of a single debt—*that it cannot be properly considered as the giving of collateral security.* And the courts have in every instance distinguished such situation from that in which the securing obligation is a mortgage bond of the corporate pledgor. *Union Nat. Bank* v. *People's Savings & Trust Co.*, 28 F. (2d) 326 (C. C. A. 3rd, 1928); *People* v. *E. Remington & Sons*, 54 Hun (N. Y.) 480 (Sup. Ct., G. T., 4th Dept., 1899); *In re Matthews, Inc.-In re Knickerbocker Trust Co.*, 188 Fed. 445 (S. D. N. Y., 1911).

The force of the distinction is best illustrated by the cases of *In re Waddell-Entz Co.*, 35 Atl. 257 (Conn., 1896), and *Mercer* v. *Steil*, 117 Atl. 689 (Conn., 1922), both decided by the highest court of Connecticut. The first of these involved the two-note situation and the court, after denying proof on the pledged note, stated that proof should be denied

> "unless such additional promises are themselves secured by a lien on property, * * *. Under such circumstances, they may be treated as collateral security, so far as is necessary to obtain the benefit of the lien or obligation." (p. 258).

Mortgage bonds pledged to secure a note were involved in the second case, and the court held that the bonds in the hands of a purchaser from the pledgee-obligee were provable in their face amount, pointing out that the bonds were

collateral security within the definition laid down in the *Waddell-Entz* case.

In *Peacock* v. *Phillips*, 93 N. E. 415 (Ill., 1910), *supra*, in which case, after holding that under Illinois law the holder of an individual's pledged note and mortgage could not claim for the face amount of the mortgage debt, the court stated that the same rule did not apply in the case of pledged corporate bonds, saying (p. 417):

> "The mortgage or trust deed secures the holders of the bonds, and they can be enforced by such holders for the full face value, regardless of equities."

The pledging of a mortgage bond to secure a loan is, as these cases recognize (see also the many cases cited in petitioners' main brief, pp. 17-20), a perfectly legitimate form of corporate financing. It is erroneous to analogize the superficially similar but, realistically considered, different situations.

The approach of the court in the *Hitner* case is justified in a situation such as that involved in *Mississippi Valley Trust Co.* v. *Railway Steel Spring Co.*, 258 Fed. 346 (C. C. A. 8th, 1919), *supra*. The basis of that decision was that the bonds were, under the law of Missouri, the corporation's domicile, not validly issued when pledged, and *hence that the pledge created no promissory obligation*. Where, as in the instant cases or in the *Hitner* case, it is established that pledged bonds are validly issued, to hold that their promissory aspect is eliminated by the institution of bankruptcy or receivership proceedings is manifestly inconsistent. Such bonds are as validly issued as are other bonds of the debtor sold outright; they constitute single commitments,

having a dual character, *i. e.*, promissory and security. In neither aspect is their character qualified. That they are valid obligations implies that there is a promissory obligee as well as an obligor. That obligee must be the pledgee. Neither bankruptcy nor insolvency of the obligor can *ipso facto* change that relationship, and destroy the pledgor's obligation upon the bond.

In the *Hitner* case the court broke up the single contract evidenced by the bond into its promissory and security aspects and then, mistakenly applying the analogy of the two-note cases, found that in its promissory aspect the bond was only a qualified obligation, ineffective after insolvency. Thus to break up an essentially unitary bond and then qualify it in one of its essential aspects—a construction never within the contemplation of the parties—and that on the basis of cases in which the courts were careful to distinguish the mortgage bond situation, is obviously unsound.

The untenable character of the court's position in the *Hitner* case is clearly established by the admission of the court in that case *that a purchaser of the pledged bonds would acquire the right to enforce the same against the pledgor.* The court said (p. 398):

> "It was argued that if the banks could sell and transfer the first mortgage bonds held by them as collateral to a third person, conferring upon the purchaser a right to participate not only in the proceeds of the mortgaged property, but in the general assets, the banks themselves without such sale and transfer would have the same right to participate in both funds. But this is a fallacy. *The bonds in the hands of the purchaser would represent unconditional indebtedness of the steel company and liability to pay its amount,* whether they were purchased for

more or less than their face value. But while remaining in the possession of the banks purely as collateral security they do not as between the steel company and the banks represent such an indebtedness. It was further contended that if the banks for the purpose of realizing on their collateral had exposed the first mortgage bonds for sale and become bona fide purchasers, they could, equally with a third person purchasing the same, have resorted to both funds. *This is true,* subject to the qualification that the net purchase price would operate as a payment on account of the original indebtedness for which the bonds had been delivered as collateral. Upon such purchase the bonds would *ipso facto* cease to be held by the banks as collateral, and would *represent actual unconditional indebtedness and liability on the part of the steel company;* the consideration for the change being the part payment of the original indebtedness resulting from the purchase of the bonds by the banks, such part payment, other things being equal, increasing the chance of payment in full of the original indebtedness through the application of dividends from the general assets."

As previously pointed out, there can logically be no difference between the rights of a pledgee of bonds and a purchaser from the pledgee to prove against the insolvent estate of the obligor on those bonds. The only distinction between the two situations is that in the former there is a limitation on the total amount of dividends received upon the combined claims which can be ultimately appropriated by the pledgee.

4. In the fourth situation, in which a purchaser of corporate bonds from the pledgee who has purchased said

bonds before bankruptcy seeks to prove upon such bonds against the bankrupt corporate obligor, the right to prove is squarely established by *Turner* v. *Metropolitan Trust Co.*, 207 Fed. 495 (C. C. A. 9th, 1913), in which the court said (pp. 499-500):

> "The attempt to make a distinction between the rule which governs contracts of pledge, where the pledgor prefers to pledge its own mortgage bonds as collateral, and that which governs such contracts, where the pledgor pledges the bonds of another corporation, is not well founded. *The contract measures the rights of the parties; and where the expressed intention is that in case of foreclosure the bonds deposited may be sold as existing securities, and the pledgee is given the right to become the purchaser, why should there be any less good title conveyed to such purchaser than if he were selling the bonds of another corporation?*
>
> "* * * A corporation which has issued its bonds frequently pledges them as collateral security for a debt. *Nor is it unusual that in suits for foreclosure the bonds pledged are offered at public sale and are purchased by the pledgee, who is entitled to the full face value of the bonds.*"

In a similar situation in receivership, the right to prove was upheld in *Atlantic Trust Co.* v. *Woodbridge Canal & Irrigation Co.*, 86 Fed. 975 (C. C., N. D. Cal., 1897).

5. In the fifth situation, that in which a purchaser of a bond from the pledgee, who has purchased after the bankruptcy of the corporate obligor, seeks to prove on the bond against the bankrupt corporate-obligor—*i. e.*, the situation presented in the instant cases—the right to prove is estab-

lished by *Jerome* v. *McCarter*, 94 U. S. 734 (1876), and *In re Ironclad Mfg. Co.*, 192 Fed. 318 (C. C. A. 2d, 1912).

In the *Jerome* case, this Court said (p. 739):

> "There is some proof that, when the company became bankrupt (Aug. 28, 1872), some of the bonds were held as collaterals for loans made to the company smaller in amount than the bonds pledged. But the bonds were subsequently sold by the pledgees, *and the present holders hold them by absolute right. The position that the pledgees could not sell the pledge after the adjudication in bankruptcy, is quite untenable.* It is sustained by nothing in the Bankrupt Act. The bonds were negotiable instruments. They passed by delivery, and even were there no expressed stipulation in the contracts of pledge, that the pledgee might sell on default of the pledgor, such a right is presumable from the nature of the transaction. *Certainly the Bankrupt Act has taken away no right from a pledgee secured to him by his contract.*"

The contrary language in *In re Battle Island Paper Co.*, 259 Fed. 921 (N. D. N. Y., 1919), is founded upon the same erroneous analysis which characterizes the *Hitner* case, *supra*, p. 40.

In similar situations arising in receivership proceedings, the principle set forth in *Jerome* v. *McCarter* has been frequently asserted. *Mercer* v. *Steil*, 117 Atl. 689 (Conn., 1922), *supra*; *Guaranty Trust Co.* v. *Galveston City R. Co.*, 87 Fed. 813 (C. C. A. 5th, 1898); *Fidelity Insurance, Trust & Safe-Deposit Co.* v. *Roanoke Iron Co.*, 81 Fed. 439 (C. C., W. D. Va., 1896); *Morris & Whitehead* v. *East Side Ry. Co.*, 104 Fed. 409 (C. C. A. 9th, 1900); *Miller* v. *American Bank & Trust Co.*, 100 S. E. 864 (W. Va., 1919); and

Rogers Brown & Co. v. *Tindel Morris Co.*, 271 Fed. 475 (E. D. Pa., 1921). In the last of these cases, the court correctly stated the governing principle when it said (p. 476):

> "In its concrete form, applied to the facts of this case, the question is: May a debtor pledge his own mortgage bond as collateral for his debt? The question has been authoritatively answered in the affirmative. Turner *v.* Metropolitan Trust Co., 207 Fed. 495, 125 C. C. A. 157. Having the right to receive and hold such a pledge, with the power to sell, *the right to exercise the power follows.* Jerome *v.* McCarter, 94 U. S. 734, 24 L. Ed. 136."

From the foregoing, petitioners submit that the First and Refunding Bonds of the Debtor held by them were valid and subsisting obligations of the Debtor from the moment of their pledge and were, therefore, fixed obligations absolutely owing at the time of the filing of the petition under Section 77. The filing of that petition did not, and a sale of the bonds will not, in any way change their character, and hence claims on those bonds should be provable equally with all other debts of the Debtor. It follows, therefore, that there is no merit to the contention of the General Mortgage Committee that the petitioners in the instant cases should be enjoined from selling the Debtor's mortgage bonds which they hold as collateral on the ground that to permit such sale would be to allow the creation of new claims against the Debtor after the filing of the petition under Section 77.

II.

Even if the First and Refunding Bonds pledged by the Debtor would not constitute provable claims in an ordinary bankruptcy proceeding, such bonds nevertheless constitute provable claims under Section 77.

Assuming, for argument, that the position taken in Point I, *supra*, is incorrect, and that the pledge by the Debtor in the instant cases of its own mortgage bonds to petitioners did not create perfected obligations of the Debtor, it does not follow that such pledge did not create claims provable under Section 77.

Even if under Section 63(a) of the Bankruptcy Act a claim to be provable in an ordinary bankruptcy proceeding must be a fixed liability absolutely owing, in the strictest sense of that term, at the time the petition is filed, petitioners submit that such limitation can have no effect in a proceeding under Section 77. Section 77(b) provides (Appendix to R. F. C. brief, p. 93) that:

> "The term 'creditors' shall, except as otherwise specifically provided in this section, include, for all purposes of this section and of the reorganization plan, its acceptance and confirmation, all holders of claims, interests, or securities of whatever character against the debtor or its property, including claim for future rent, *whether or not such claims, interests, or securities would otherwise constitute provable claims under this Act.*"

Petitioners contend that this language explicitly negatives the applicability of Section 63(a) to a proceeding under Section 77. Furthermore, it makes clear that the

holders of any securities of the debtor, whatever the character thereof, have provable claims against the debtor. And still further, this provision makes it clear that claims arising against the debtor after the petition under Section 77 is filed and during the period determined by the Act or the court for the filing of proofs of claim may be proved against the debtor.

It is naturally to be expected that a broader class of claims should be admitted to proof in a proceeding under Section 77 than in an ordinary bankruptcy proceeding. All the provisions of the Bankruptcy Act, as it existed before the enactment of Section 77, and the interpretation of those provisions, particularly those having to do with provable claims, were dictated by the fundamental consideration that, upon bankruptcy, the estate of the bankrupt became a trust fund to be liquidated for the benefit of creditors, and that claims had to be satisfied from that fund and that alone. Strict limitations upon the right to prove claims were therefore necessary. Under Section 77, on the other hand, no liquidation is contemplated; on the contrary, that Section looks to a continuation of the debtor's enterprise. The only change contemplated is a readjustment of the various equities in that enterprise. Accordingly, since the possibility of realization is not forever barred by a proceeding under Section 77, as is true in an ordinary bankruptcy proceeding, there is no necessity for as strict a limitation upon the character of claims which shall be entitled to participate in the redistribution of the equitable interests in the debtor's enterprise.

That this is so is indicated by the fact that, although in an ordinary bankruptcy proceeding claims which are not provable under Section 63(a) are not discharged, in a

proceeding under Section 77 every claim against the debtor, whether or not provable under Section 63(*a*), may be discharged. (See Section 77(h)(7); Appendix to R. F. C. Br., p. 103). If Section 77 were to be construed as discharging the debtor from all his obligations whether the obligees on such obligations were permitted to participate in the redistribution of the equitable interests in the debtor's enterprise or not, the Section would encounter serious constitutional difficulties under the due process clause of the Fifth Amendment.

Petitioners submit, therefore, that when the Debtor's petition under Section 77 was filed, they as pledgees of the Debtor's First and Refunding Bonds had a provable claim thereon against the Debtor, and that there is no reason why petitioners cannot now sell the bonds held by them as collateral security and thereby vest in the purchasers of those bonds provable claims against the Debtor. Moreover, petitioners submit that whether or not *petitioners* have a provable claim on the pledged bonds, there is no valid reason why they should not be permitted, by the exercise of their express contract right, to sell the pledged First and Refunding Bonds with the result that a *purchaser* thereof would have a valid, provable claim thereon.